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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956.

NO. 754

WILLIAM G. LIAS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

WILLIAM G. LIAS and ALICE B. LIAS, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION OF WILLIAM G. LIAS AND ALICE B. LIAS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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To the Honorable, the Chief Justice of the United States and The Associate Justices of the Supreme Court of the United States:

The Petitioners, William G. Lias (referred to herein as "Petitioner Lias") and Alice B. Lias (referred to herein as "Petitioner Alice Lias") respectfully pray that a writ of certiorari issue to review judgments of the United States Court of Appeals for the Fourth Circuit affirming decisions of the Tax Court of the United States, which sustained deficiencies in federal income taxes and penalties, assessed by the Respondent, the Commissioner of Internal Revenue (referred to herein as "Respond-

ent") against Petitioner Lias for the years 1942 to 1947, inclusive, and against Petitioner Lias and Petitioner Alice Lias for the year 1948.*

OPINIONS BELOW

The Opinion of the Tax Court of the United States is reported at 24 T.C. 280 and is included in the Petitioners' Appendix in the Court below at pages 1101a to 1169a. The Opinion of the Court below is reported at 235 F. (2d) 879 and a copy thereof is appended hereto.

GROUNDS OF JURISDICTION

The judgments sought to be reviewed are judgments of the United States Court of Appeals for the Fourth Circuit, which were entered on August 3, 1956.

A petition for rehearing was filed within the prescribed period and was denied by the Court below, without opinion, on September 11, 1956.

On November 14, 1956, this Court made an order extending the time for filing this Petition to and including February 8, 1957. The Petitioners duly notified the Solicitor General of the United States of the extension.

The jurisdiction of this Court to entertain this Petition is based upon 28 U.S.C., § 1254(1).

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* Record references are to the Appendices filed by the Petitioners and the Respondent in the Court below, the Petitioners' Appendix being designated by the abbreviation "P.A." and the Respondent's by the abbreviation "R.A." In most instances, references are to the Tax Court's Opinion.

THE QUESTIONS PRESENTED FOR REVIEW

1. May the Commissioner of Internal Revenue determine deficiencies in federal income tax against a taxpayer by using a consolidated net worth and expenditures formula under which the taxable income of the taxpayer is computed by subtracting from the aggregate amounts of consolidated net worth increases and consolidated expenditures of the taxpayer and several other persons the amounts of income reported for income tax purposes by the other persons?

2. Has the Commissioner of Internal Revenue sustained his burden of proof with respect to fraud where, in determining a taxpayer's taxable income by use of a consolidated net worth and expenditures formula, the Commissioner fails to prove (a) that the other members of the consolidated group correctly reported their taxable income and (b) that the other members had no cash on hand at the beginning of the taxable period, and where the only evidence of fraud is an inference arising from suostantial discrepancies between the amounts of taxable income as reported by the taxpayer and the amounts of taxable income as so determined by the Commissioner?

THE STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1952 ed., Sec. 22.)

* * * * * * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or

does not keep books, the net income shall be computed on the basis of the calendar year.
(26 U.S.C. 1952 ed., Sec. 41.)

* * * * * * *

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in Section 276—

(a) *General Rule.* — The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

(26 U.S.C. 1952 ed., Sec. 275.)

* * * * * * *

SEC. 276. SAME—EXCEPTIONS.

(a) *False Return or No Return.* — In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

(26 U.S.C. 1952 ed., Sec. 276.)

* * * * * * *

SEC. 1112. BURDEN OF PROOF IN FRAUD CASES

In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof of such issue shall be upon the Commissioner.

(26 U.S.C. 1952 ed., Sec. 1112.)

* * * * * * *

STATEMENT OF THE CASE

On December 20, 1949, the Respondent determined deficiencies in federal income taxes against Petitioner Lias for the years 1942 to 1946, inclusive, against Petitioner Lias for the year 1947 and against the Petitioner Lias and the Petitioner Alice Lias, wife of Petitioner Lias, for the year 1948, with respect to which Petitioners had filed a joint return. In addition, penalties for fraud with intent to evade tax (50%) were assessed with respect to all the taxable years and for substantial under-estimates of estimated tax (6%) with respect to all years except 1942 and 1948.

Petitions for redetermination of the deficiencies were duly filed with the Tax Court of the United States pursuant to § 272 of the Internal Revenue Code of 1939 (26 U.S.C. § 272) and were docketed at No. 27264 (involving the Petitioner Lias for the years 1942 and 1946, inclusive) and at No. 27762 (involving the Petitioner Lias for the year 1947 and both Petitioners for the year 1948). The proceedings were consolidated for hearing and decision in the Tax Court (See Tax Court Opinion, P.A. 1102a).

After an extended hearing (the transcript before the Tax Court covered approximately 7,150 pages), the Tax Court, on May 26, 1955, filed its Opinion, including findings of fact and conclusions of law, sustaining the Respondent's determination in every substantial respect (P.A. 1101a *et seq.*). Pursuant to this Opinion, decisions were entered, under Rule 50 of the Tax Court, on September 12, 1955, determining deficiencies and penalties against Petitioner Lias for the years 1942 to 1947, inclu-

sive, in the aggregate amount of $1,985,729.15, including 50% fraud penalties of $634,876.68 for all years and 6% under-estimate penalties of $81,974.13 for the years 1943 to 1947, inclusive, and against both Petitioners for the year 1948 in the amount of $26,493.03, including a fraud penalty of $8,831.01. Moreover, in addition to imposing fraud penalties, the Tax Court also held that the deficiencies for the years 1942, 1943 and 1944 were not barred by the three-year statute of limitations because the returns for such years were fraudulent (P.A. 1168a).

A brief review of the facts leading to the deficiency assessments and of the Respondent's method of determining the deficiencies may be in order. Except where otherwise indicated by reference to specific testimony, the facts are taken from the Tax Court's findings.

The Petitioner Lias, during the years 1942 to 1945, inclusive, was engaged in the business of gambling in the area of Wheeling, West Virginia, where he had his home (P.A. 1104a to 1108a). Throughout most of this period gambling, although unlawful, was openly permitted by the municipal authorities on an informal licensing basis (P.A. 1107a; 1166a; see testimony R.A. 1049 to 1055). The Petitioner Lias also engaged in other business endeavors (P.A. 1108a-1109a). His gambling activities were carried on through several partnerships and corporations in which others (relatives or outsiders) usually had some proprietary interest (P.A. 1105a to 1108a). The activities engaged in by these organizations were varied; there were gambling establishments, so-called "horse books" and slot machines (P.A. 1105a to 1107a). These partnerships and corporations kept

books and records and filed tax or information returns (P.A. 1119a-1120a; see testimony P.A. 21a to 26a).

The Petitioner Lias' federal tax returns for the years in issue were prepared by a Certified Public Accountant, a Mr. Goldberg (P.A. 1119a-1120a), who also had set up the accounting systems for most of the entities in which the Petitioner Lias was interested (see testimony P.A. 18a to 26a). The Tax Court found, contrary to the contentions of Petitioner Lias, that he did not keep permanent personal books of account; Mr. Goldberg prepared his returns (and those of Petitioner Alice Lias) from the books and records of the various partnerships and corporations in which Petitioner Lias was interested and from which he derived income, from Petitioners' bank books and checks and receipts and from information furnished by them (P.A. 1120a). The Petitioner Lias paid substantial amounts of federal income tax in all the years in issue; the Petitioner Alice Lias paid such taxes in all years except 1945 and 1947 (P.A. 1138a).

The Petitioner Lias was indicted, in the United States District Court for the Northern District of West Virginia, for wilfully and knowingly attempting to defeat and evade federal income taxes for five of the years in issue (1942 to 1946) and after a jury trial was acquitted on July 2, 1949 (P.A. 1141a).

In practically all of Petitioner Lias' business activities, gambling or otherwise, certain members of his family had interests of varying amounts. These were his wife, the Petitioner Alice Lias, his brother, John Lias, his brothers-in-law, Gregory and William Koutroumanos (also called "Manos" and so referred to herein),

his children, George B. and Antoinette Lias, and, to a minor extent, his mother-in-law, Mary Koutroumanos (Manos) (see P.A. 1104a and 1141a *et seq.*). The Petitioner Lias handled and invested all of the funds of the group as he "saw fit" (P.A. 1148a). The members of the group paid substantial amounts of federal income tax (P.A. 1144½a).

The crux of this case is the method used by the Respondent, with the approval of the Tax Court and the Court below, to determine the Petitioner Lias' taxable income. It is based on the device commonly known as the "net worth" or "net worth and expenditures" method, with this novel and significant extension, that, instead of using the Petitioner Lias' individual net worth increases and expenditures, the Respondent's calculations are made on a *consolidated* basis, using the changes in net worth and expenditures of the group *as a whole,* and the Petitioner Lias is charged with *all* the income resulting from the calculation except such as was reported (as adjusted) for federal income taxes by other members of the family group. (In using the term "adjusted", we do not mean to imply that the Revenue Agents made any adjustments based on the net worth calculation; the adjustments were minor technical items.)

The "key" witness for the Respondent on this point was Revenue Agent Harold E. Young who produced and explained the basic consolidated net worth schedules, which are in effect summarized in Schedules A and B to the Tax Court's Opinion (P.A. 1143a, 1144a and 1144½a). According to Mr. Young, he computed the

aggregate net worth of the entire group at the end of each year, beginning with the date December 31, 1941 and ending with December 31, 1948 (P.A. 881a to 885a); to increases in such net worth, he added the group's consolidated non-deductible expenditures for each year and from these results he subtracted non-taxable income to arrive at, for each year, what he termed "a corrected taxable income for the family as a whole" (P.A. 913a). According to his testimony, he made no effort to calculate individual net worth changes or expenditures (P.A. 974a) but treated all eight members of the family as a unit (P.A. 966a and 974a). From the consolidated net income figures thus computed, he then deducted the taxable income of each other member of the group (except for Mary Manos and the Petitioner Lias' children, who presumably had no such income) as reported or adjusted, leaving amounts which, he states, would be the "corrected net income" of Petitioner Lias for the years in issue (P.A. 913a and 914a).

This procedure the Tax Court has described as follows (P.A. 1149a):

> "The combined taxable net income of the petitioner, his wife, his brother, and brothers-in-law, was determined by taking the increase in their combined net worth during each year, adding federal income taxes, insurance premiums, and personal expenses paid during each year, and making proper adjustments for capital gains and losses. From such combined taxable net income there was deducted the income reported or adjusted for the other members of the family group, leaving the taxable net income of the petitioner."

The Tax Court, it should be noted, makes no reference to Mary Manos or the Petitioner Lias' children at this point although they were actually included in the computations, probably because the Court did not consider their contributions to net worth to be of any great significance.

Another aspect of Mr. Young's computations should be mentioned. In his opening net worth figures (at December 31, 1941), he gives no credit for cash on hand (P.A. 916a). With respect to the Petitioner Lias' own funds, this may be of no significance, because the Tax Court found, against his testimony and that of numerous other witnesses, that he had no cash on hand (P.A. 1122a). Mr. Young further testified, however, that he did not take into account any cash which other members of the group may have had on the opening date (P.A. 968a), he did not interrogate any of them as to their cash reserves (P.A. 916a-917a) and he did not know of any other agent connected with the investigation of Petitioner Lias who had made such an interrogation (R.A. 962).

As indicated, the Tax Court sustained the Respondent's determination of deficiencies based on the consolidated net worth method (P.A. 1150a), holding, in effect, that the Petitioner Lias had the burden of proving a proper allocation of consolidated net worth increases and expenditures. It also (a) sustained deficiencies as to the years 1942, 1943 and 1944, which otherwise would have been barred by the statute of limitations, on the ground that the Petitioner Lias' returns for such years were fraudulent (P.A. 1168a) and (b) on the same ground of fraud, upheld 50% penalties for all the years at issue (P.A. 1168a).

Before the Tax Court the Petitioners vigorously contested the deficiencies on the facts, but since the factual issues were generally determined against the Petitioners they will not be discussed here or in the succeeding Argument. In addition, there were a number of legal questions presented to the Tax Court and the Court below which will not be referred to in this Petition because they are not considered as involving grounds for certiorari.

Within the time allowed by statute, the Petitioners filed petitions to review the Tax Court's decisions with the United States Court of Appeals for the Fourth Circuit, within the jurisdiction of which (at Parkersburg, West Virginia) the Petitioners' federal income tax returns were filed. The jurisdiction of such Court was invoked under § 7482 of the Internal Revenue Code of 1954 (26 U.S.C. § 7482). The Court of Appeals, as previously indicated, affirmed the Tax Court's rulings.

REASONS FOR GRANTING THE WRIT AND ARGUMENT

I.

The Court Below in Affirming the Decision of the Tax Court That the Commissioner of Internal Revenue May Determine a Taxpayer's Taxable Income on a Consolidated Net Worth and Expenditures Basis Has Decided an Important Question of Federal Law Which Has Not Been, But Should Be, Settled by This Court.

In the succeeding section of this Argument (Part II), the Petitioners will endeavor to demonstrate that the Respondent's formula for determining taxable income in this case (which we refer to, for convenience, as the "consolidated net worth and expenditures" method or formula) has been used to shift the burden of proof as to fraud from the Respondent to the Petitioners. From the standpoint of the effect on these particular Petitioners, that may be the more important issue in the case in that the imposition of fraud penalties and the exposure of the Petitioner Lias to liability for closed years lifts the amounts involved to almost astronomical proportions. On the other hand, from the standpoint of taxpayers in general and as a matter of basic tax principles, the question as to whether the Respondent's formula may be used *at all* is the more important issue, one which the Petitioners believe should be decided by this Court.

The Court below and the Tax Court seem to have sanctioned the consolidated net worth and expenditures formula for three reasons: (1) the Respondent's deter-

minations of income are *prima facie* correct; (2) the formula is merely an adaptation of the individual net worth method, already fully sanctioned by this Court; and (3) the Petitioners invited the use of the method by creating a confusion of assets within the consolidated group.* However, none of these arguments can negate basic concepts that the formula is absolutely unique in federal income tax law, it involves a determination by the Respondent which is not within the basic framework of the Internal Revenue Code and it has many dangerous potentialities—all of which invite scrutiny by the ultimate authority on federal tax laws.

It is true that the Respondent's determinations with respect to federal tax liabilities are normally *prima facie* correct. On the other hand, the presumption of correctness disappears if the determination is arbitrary.

Thomas v. Commissioner, 232 F. (2d) 520 (C.A. 1, 1956)

Thomas v. Commissioner, 223 F. (2d) 83 (C.A. 6, 1955)

So far as the Petitioners have been able to determine, the consolidated net worth and expenditures formula is a novelty in federal tax law. The Tax Court, fully experienced in all methods of income determination, observed that the technique did "not appear to have been resorted to heretofore" (P.A. 1150a) and described it as "unusual" (P.A. 1150a). The use of a combined net worth formula in the case of married tax-

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* It is significant that in the Petitioner Lias' criminal trial, dealing with the years 1942 to 1946, inclusive, the Government employed an *individual* net worth and expenditures formula (R.A. 1099 *et seq.*).

payers, which has been occasionally sanctioned, is no precedent because the revenue statutes provide for joint returns.

Section 41 of the Internal Revenue Code of 1939 (26 U.S.C. 41) provides that "if no such (regular) method of accounting has been so employed (by a taxpayer), or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income * * *." While this gives wide latitude to the Commissioner to reconstruct a taxpayer's correct income on any reasonable basis, there is no authority or implication of authority to depart from the framework of the tax laws and combine the accounting of several separate taxpayers. There are many specific provisions of the Internal Revenue Code dealing with transactions between related taxpayers, with the allocation of income among affiliated groups and with the consolidation of income as in the cases of husband and wife and affiliated corporations, but none which would cover a situation such as the instant one. The implications of the consolidated net worth and expenditures formula cannot be restricted by pointing out that this involved a family group (if it can be called such) for the Courts below sanctioned the device, not because a family was involved, but because ownership of assets was confused and shifting, which would make it applicable to any group, large or small, related or not.

This Court, in the *Holland* case (*Holland v. United States*, 348 U.S. 121, 75 S. Ct. 127, 99 L. Ed. 150 (1954)), and companion cases, pointed out the many dangers

which lurk within the individual net worth formula and stated:

> "Nevertheless, careful study indicates that it is so fraught with danger for the innocent that the courts must closely scrutinize its use."
>
> * * * * * * *
>
> "Trial courts should approach these cases in the full realization that the taxpayer may be ensnared in a system which, though difficult for the prosecution to utilize, is equally hard for the defendant to refute."
>
> * * * * * * *
>
> "Appellate courts should review the cases, bearing constantly in mind the difficulties that arise when circumstantial evidence as to guilt is the chief weapon of a method that is itself only an approximation."

It should be obvious from these warnings that the method should not be drastically extended, as in the instant case, without careful consideration of the ultimate consequences, a consideration which only this Court can give the problem. Some of the dangers, we may add, are indicated in the application of the formula in the instant case as developed in the succeeding section of this Petition.

II.

The Decision of the Court Below Affirming the Decision of the Tax Court That the Petitioner Lias Was Guilty of Fraud With Intent to Evade Tax Is in Conflict With Applicable Decisions of Other United States Courts of Appeal in Cases Involving the Burden of Proof of the Commissioner of Internal Revenue With Respect to the Issue of Fraud.

The decision of the Tax Court on the issue of fraud in this case, which was affirmed and adopted by the Court below (the Court of Appeals based its opinion almost entirely on the Tax Court's opinion—see Appendix A), can be summarized as follows: (a) the use by the Respondent of the consolidated net worth and expenditures formula to determine the Petitioners' taxable income was proper under the circumstances, (b) by the application of such formula, it was determined that the taxable income of the Petitioner Lias in each of the years in issue was substantially understated on his returns, (c) such understatements of taxable income established a *prima facie* case of fraud and (d) Petitioners failed to prove that there was no justification for the imposition of fraud penalties and the assessment of deficiencies for taxable years barred by the statute of limitations.

In analyzing the opinion of the Tax Court, as approved by the Court below, it is apparent that it rests solely on the fact that the Respondent's application of the consolidated net worth and expenditures formula showed substantial discrepancies between the Petitioner Lias' reported taxable income and the income

constructed for *him* (*not* the consolidated group) by the Respondent. The Tax Court, if its Opinion be carefully analyzed, did not rely upon any other evidence as sustaining the Respondent's burden of proof on the fraud issue. Thus the Tax Court declared, after stating that the burden of proof on the fraud issue was on Respondent, that:

> "The repeated understatement of income in each of the taxable years by percentages ranging from a minimum of 137 per cent in 1946 to a maximum of 488 per cent in 1944 establishes a *prima facie* case of fraud" (P.A. 1163a).

In resting its decision on this one factor, the Tax Court, as well as the Court below, acted in direct conflict with several decisions of the United States Courts of Appeals which hold that it is incumbent upon the Commisioner of Internal Revenue, in any proceeding involving the issue of fraud, to prove the existence of fraud on the part of a taxpayer by clear and convincing evidence. Fraud may not be presumed, nor may it be inferred from suspicious circumstances; the Commissioner has the burden of proving *each* and *every* element necessary to sustain a finding of fraud. At no point in the chain of proof may the burden be shifted to the taxpayer.

As stated in *Davis v. Commissioner,* 184 F. (2d) 86 (C. A. 10, 1950):

> "Fraud implies bad faith, intentional wrong doing and a sinister motive. It is never imputed or presumed and the courts should not sustain findings of fraud by circumstances which at the most create only suspicion."

And again in *Drieborg v. Commissioner*, 225 F. (2d) 216 (C.A. 6, 1955), it was said:

> "At the outset it should be emphasized that the failure of the taxpayers to overcome the presumptive correctness of the deficiencies, even though those deficiencies cover a consecutive ten year period, cannot be regarded, in and of itself, as sufficient proof that the deficiencies or any part thereof were due to fraud on the part of the taxpayers. To hold otherwise would be to ignore the statute which imposes on the Commissioner the burden of proving fraud, and the often repeated admonition that such proof must be by clear and convincing evidence. There must be additional independent evidence from which fraudulent intent on the part of the taxpayer can be properly inferred."

The Court of Appeals for the Fifth Circuit has similarly described the burden of proof (*Bryan v. Commissioner*, 209 F. (2d) 822, (C.A. 5, 1954)), stating:

> "While ordinarily a determination of tax liability made by the Commissioner is presumptively correct and the burden rests upon the taxpayer to prove it erroneous, in any proceedings involving the issue of fraud with intent to evade tax, the burden of proof with respect to the issue of fraud is upon the Commissioner. Thus in any case where a deficiency in tax is determined by the Commissioner after the three year period of limitation has expired and the civil fraud penalty is asserted, the burden is upon the Commissioner, in an appropriate proceeding where the validity of an assessment based upon such determination is contested, to establish

by clear and convincing proof the existence of fraud."

See also:

Commissioner v. Cutcliffe, 163 F. (2d) 891 (C.A. 5, 1947), affirming 5 T.C.M. 673 (1946)

Kastel v. Commissioner, 136 F. (2d) 530 (C.A. 5, 1943)

The Respondent, the Petitioners submit, has failed to sustain his burden of proof in the instant case in the following respects:

First, and this is of the utmost significance, by his application of the consolidated net worth and expenditures method, the Respondent has avoided producing any specific evidence that the *individual* taxable income of the Petitioners was understated in any of the years involved;

Second, Respondent failed to offer any evidence of fraud in addition to the point that the Petitioners' taxable income *as so determined by the consolidated net worth and expenditures formula* was substantially understated in the taxable years; and

Third, Respondent failed to prove that the aggregate net worth of members of the consolidated group was correct, in that he neglected to offer evidence that the members of the group, other than the Petitioner Lias, had no amounts of cash on hand at the opening of the taxable period.

Argument.

A. *The Commissioner of Internal Revenue Used the Consolidated Net Worth and Expenditures Formula as a Substitute for Evidence to Sustain His Burden of Proof of Fraud.*

As pointed out in the preceding section of this Argument (Part I), there is grave doubt as to the propriety of using the consolidated net worth and expenditures formula even in determining a deficiency in income tax of a taxpayer, although normally the Commissioner's determination is accepted as *prima facie* correct and as placing the burden of proof on the taxpayer. There would seem to be far less justification for sanctioning the use of the formula to supply proof of fraud on the part of a member of the group, inasmuch as the formula, as applied in the instant case, by its very nature operates to avoid the Commissioner's burden and shift it to the taxpayer.

This inherent defect in the formula readily appears when we consider the last step in the determination of the Petitioner Lias' taxable income under the formula. After determining the "corrected" consolidated net income of the entire group, the Respondent arrived at the Petitioner Lias' share (and the share of both Petitioners for 1948) by deducting from the consolidated amount the individual amounts of taxable income reported by the others on their individual tax returns for the years involved. No evidence of any kind was offered to show that the amounts of taxable income so reported by the others were in fact the correct amounts. The Respondent did not call them as witnesses, nor did he attempt to compute their individual net worth changes. He

merely *assumed* their returns were correct. Thus the formula used by Respondent, by his own admission, is based squarely on a completely unproved assumption of fact.

The use of the formula in this case was found to be justified on the basis of the assertion that the assets of the consolidated group were so intermingled and the affairs of the group so confused that it was impossible to compute the individual net worth of the Petitioner Lias. If this be the fact, then it also follows that it was impossible to compute the individual net worth of other members of the group. It is thus difficult to see on what theory the taxable income of the others can be accepted as correct without proof and the balance of the consolidated net income be treated as the "correct" taxable income of the Petitioner Lias. The Respondent could just as well have accepted the Petitioner Lias' returns as correct and attributed the excess income to all or some or one of the other members of the group.

The Court below justifies this curious result of charging all the unreported consolidated income to Petitioner Lias, on the ground, in the words of the Court, that "no member of the group appeared to claim participation in excess of the amounts taxed to them", which practically echoes language of the Tax Court (P.A. 1156a) that the Respondent "was under no obligation to have them (the other members) sworn" and that the "inference may be drawn that, if called, their testimony would not have been favorable" to Petitioners. Since the issue was one of fraud, the Petitioner Lias could have no obligation to procure such testimony. Rather, it was Respondent's burden to prove, as prac-

tically all the authorities say, by clear and convincing evidence, that the other members of the group were *not* entitled to "participation in excess of the amounts taxed to them." The Court below, as well as the Tax Court, in conflict with well established principles of law, not only failed to require the Respondent to meet the burden of proof on this essential point, but in no uncertain terms shifted the burden to the Petitioners, thus failing to distinguish between the issue of tax liability and the issue of fraud.

The holding of the Courts below, is not only inconsistent with a great many decisions of the Courts of Appeal and the Tax Court itself,* but it has far-reaching effects of importance to all taxpayers. Its effect is to extend the concept of the *prima facie* correctness of the Commissioner's determination of a deficiency beyond the mere assessment of such deficiency to the imposition of fraud penalties based solely upon the taxpayer's failure to rebut the determination. The result is to obliterate the safeguards which Congress saw fit to provide to protect citizens against arbitrary and unwarranted assertions of fraud by the taxing authorities, safeguards which are particularly needful when Congress has at the same time provided the same authorities with drastic powers for assessing taxes. This is certainly a problem which deserves review by this Court.

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* See, for example, *A. W. Minyard*, 6 T.C.M. 1137 (1947); *Harry Gleis*, 24 T.C. 941 (1955); *A. C. Muldoon*, 12 T.C.M. 897 (1953).

B. ***The Respondent Failed to Introduce Any Evidence of Fraud Other Than the Determination of Substantial Amounts of Unreported Taxable Income as Computed Under the Consolidated Net Worth and Expenditures Formula.***

In addition to the question of the propriety of permitting the consolidated net worth and expenditures method to serve as a substitute for evidence fulfilling the Respondent's burden of proof, there is presented the closely related (and sometimes indistinguishable) question as to whether the mere existence of an understatement of income, based upon the application of such a formula, is by itself sufficient to sustain a finding of fraud. The Tax Court has not followed an entirely consistent policy on this point; however, in this case, as in many others, it has unequivocally held that substantial and repeated understatements of income developed through the application of the formula are *prima facie* proof that the taxpayer's returns were filed with fraudulent intent to evade tax.*

While certain of the Courts of Appeal have held that a proven understatement of income by a taxpayer creates an inference of fraud, which is sufficient to sustain the Commissioner's burden of proof on the issue, other Courts of Appeal in recent years have taken the

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* Although the Tax Court refers to the Petitioner Lias' stature as a witness and his illegal activities in discussing the fraud issue, a careful reading of the opinion makes it clear that it relies solely on the deficiencies as proof of fraud.

position that a finding of fraud cannot be based solely on proof of understatement, however substantial.

Davis v. Commissioner, 184 F. (2d) 86 (C.A. 10, 1950);

Kashat v. Commissioner, 229 F. (2d) 282 (C.A. 6, 1955)

Goldberg v. Commissioner, ... F. (2d) .... (C.A. 5, 1956)

In *Goldberg v. Commissioner, supra*, the taxpayer husband and wife were engaged in the business of operating coin machines, including some slot machines. The Commissioner reconstructed taxpayers' income by use of the "cash expenditures method" and assessed deficiencies and fraud penalties for five years. The Tax Court sustained both the deficiencies and fraud penalties, basing its finding of fraud on the fact that the wife was a trained accountant and that the taxable income as determined by the Commissioner was substantially in excess of that reported (reconstructed income was in amounts ranging from 200% to 400% over that reported). The Court of Appeals, reversing as to the fraud penalties, held that omissions of large amounts of income, large only because of the presumption in favor of the Commissioner's determination, cannot be substituted for clear and convincing evidence of fraud. The Court, pointing out that great stress had been placed on the criminal record of the husband taxpayer and his numerous brushes with the Federal taxing authorities, as was the situation in the instant case, went on to say that the case was tried too much on the theory "Give a dog an ill name and hang him."

In *Kashat v. Commissioner, supra*, the Tax Court sustained deficiencies and fraud penalties for six years

which had been determined by the Commissioner by use of the net worth and expenditures method. No evidence of fraudulent intent was offered other than the fact of substantial deficiencies. The taxpayer tried to explain away the deficiencies by claiming a substantial amount of cash on hand at the beginning of the net worth period but the Tax Court disbelieved his testimony as incredible and inconsistent and pointed out that even if it were true, there would still have been sizeable unexplained increases in net worth. In sustaining fraud penalties, the Tax Court said:

> "Where large amounts of income are not reported over a number of years, where no books are kept by the petitioner, and no reasonable explanation is given for the failure to report the income, there is substantial evidence to establish fraud."

However, on appeal, the Court of Appeals reversed the Tax Court's decision with respect to the penalties and the deficiencies for years barred by the statute of limitation, saying:

> "Standing alone, however, the failure of a taxpayer to overcome the presumptive correctness of the deficiency does not of itself create a presumption of fraud. Both parties to a proceeding may fail through inadequate proof on the several issues. We recently had occasion to consider this principle in *Drieborg v. Commissioner,* 6 Cir., 225 F. (2d) 216 and, after review of the pertinent cases, concluded there must be additional independent evidence from which fraudulent intent on the part of the taxpayer can properly be inferred and that the Commissioner cannot sustain the burden the Statute puts on him merely by establishing deficiencies in tax. There

are here no other circumstances to show deliberate intent to evade."

See also *Wisely v. Commissioner,* 185 F. (2d) 263 (C.A. 6, 1950), where the Court, in setting aside fraud penalties against a taxpayer who had failed to report large amounts of taxable income, stated:

"It is true that the additional payments by petitioner were large but this within itself does not establish as a matter of law that petitioner was guilty of fraud."

Thus, there is direct conflict in the decisions of the Courts of Appeal on this point, as to whether or not the Commissioner's burden of proof on the issue of fraud requires something more than a mere showing of understatements of income, especially where, as here, the supposed understatements are based on inference. The question is basic to the proper administration of the fraud provisions of the Internal Revenue Code and is an issue which has appeared time and time again before the Tax Court and the Courts of Appeal without final solution and will no doubt continue to appear.

C. *The Respondent Failed to Sustain His Burden of Proof in That He Failed to Substantiate the Opening Net Worth Used in the Consolidated Net Worth and Expenditures Formula.*

Still another departure from the established rule that the burden of proving *every* element of fraud is on the Commissioner was the Respondent's failure to establish clearly and convincingly the opening net worth used in applying the consolidated net worth and expenditures

formula. This Court has said in *Holland v. United States*, 348 U.S. 121, 75 S. Ct. 127, 99 L. Ed. 150 (1954):

> "We agree with petitioner that an essential condition in cases of this type is the establishment, with reasonable certainty, of an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets. The importance of accuracy in this figure is immediately apparent, as the correctness of the result depends entirely upon the inclusion in this sum of *all* assets on hand at the outset." (Emphasis supplied)

If the Respondent is to compute the Petitioners' taxable income on the basis of increases in consolidated net worth, then it naturally follows that the "starting point", or opening consolidated net worth, must include all the assets of each and every member of the group. It is incumbent upon the Respondent, not only to include all such assets in opening net worth, but also to prove that such assets are *all* the assets of the group.

In the consolidated net worth statement prepared by Respondent in this case, no credit is given for amounts of cash held by Petitioner Lias or other members of the group on the opening date (December 31, 1941). With respect to the Petitioner Lias, the Tax Court found, and the Court below agreed, despite testimony to the contrary, that he had no reserves of cash, so that no complaint can be made on that score. However, there was no evidence warranting any finding that other members of the group had no cash on hand at the opening date and, on the contrary, Mr. Young, the agent who explained the Respondent's net worth schedules, specifically stated that he had not questioned any other members of the

group with respect to their cash holdings, nor did any other member of the investigating team, as far as he knew, make any such inquiry.

The opening net worth figure, as a result of this failure, is therefore based in part on supposition and not on the required clear and convincing evidence. The decision of the Court below in basing a finding of fraud upon a formula, which is in part supposition, is in direct conflict, not only with the decision of this Court in the *Holland* case, *supra*, but also with a recent decision of the Court of Appeals for the First Circuit, *Thomas v. Commissioner*, 232 F. (2d) 520 (1956), in which the Court, reversing deficiencies and fraud penalties sustained by the Tax Court because the Commissioner had failed to introduce any evidence of a positive nature that the taxpayer had no cash on hand at the beginning of the period, stated:

> "If respondent is to be permitted to make an arbitrary guess as to the proper figure for the cash on hand account, there would seem to be no reason as a general proposition why similar guesses should not be made as to each of the constituent elements comprising the taxpayers' net worth. Under these circumstances the entire net worth technique becomes nothing but an elaborate accounting sham lending a semblance of system and logic to a determination of deficiency which could have no greater validity than the original guesswork upon which it was based."

A situation somewhat similar to the one in the instant case occurred in *Bryan v. United States* 175 F. (2d) 223 (C.A. 5, 1949), involving criminal prosecution

for tax evasion for the years 1941 to 1944*. The Commissioner's auditor, who had constructed the net worth statement, testified that in arriving at opening net worth he had resorted to all the sources he could find, but he admitted that he did not know whether or not his computation included *all* the assets of the taxpayer. The taxpayer was convicted in the trial court but the Court of Appeals reversed because of the admission that opening net worth was not complete, stating:

> "* * * in view of the auditor's admissions that he was not able to say that his computation included all of the assets of the Defendant at the beginning of the period, together with the absence of any admissions, records, financial statements, bookkeeping entries, or other findings, or evidence, tending to bind the Defendant as to the lack of additional assets at the beginning of the tax period, the evidence, in the light of the bill of particulars, was insufficient to make out a *prima facie* case against the Defendant on the net worth-expenditure basis, and the case should not have been submitted to the jury since it did not exclude the hypothesis that the funds used in making some of the expenditures might have been from sources other than current business income."

In the instant case, although the Respondent may have offered proof convincing to the Tax Court that

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*Fraud penalties for the years 1935 to 1944 were sustained against the same taxpayer in *Bryan v. Commissioner*, 209 F. (2d) 822 (C.A. 5, 1954) but it does not appear that a similar admission with respect to the computation of opening net worth (for a different year than that involved in the criminal case) was made by the Government agent.

opening net worth was complete as to the Petitioner Lias, he did not fulfill the requirement with respect to group net worth, and, since he chose to use the consolidated formula, he should have made it equally complete.

III. Conclusion.

As pointed out above, the decision of the Court below in respect to principles relating to the Respondent's burden of proof on the issue of fraud is, in several particulars, in direct conflict with decisions of other Courts of Appeal. Although this Court, in the *Holland* case, *supra*, and companion cases, has recently considered the application of the net worth method and the burden of proof in criminal fraud cases, a search of the decisions indicates that it has not done so in a civil fraud case. In view of the increasing conflict in the Courts of Appeal in regard to these matters, there is need for a definitive statement by this Court with respect to their application in a civil case.

Respectfully submitted,

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APPENDIX A

Opinion of the Court of Appeals for the Fourth Circuit.

Before PARKER, Chief Judge, and SOPER and PRETTYMAN,* Circuit Judges.

PRETTYMAN, Circuit Judge: These are individual tax cases for the years 1942 to 1948, inclusive. The Tax Court of the United States sustained deficiencies and penalties totaling some $2,000,000. One taxpayer, our petitioner William G. Lias, is involved in all years, and his wife is jointly and severally liable for 1947 and 1948. The Tax Court made long and detailed findings of facts and rendered an exhaustive opinion.[1] To relate the background of this controversy, or to recite the underlying material upon which decisions of the present issues must be based, would be to repeat at considerable length what was said by the Tax Court. We see no need to do so. We shall therefore superimpose the following discussion upon the Tax Court's findings and discussion without repeating them.

Petitioners urge (1) that the Tax Court erred in approving the use of a net worth computation upon a family group basis as a means to the ascertainment of a single individual's net income; (2) that the net worth computation was erroneous, in that (a) the opening statement of assets was erroneous, (b) credit was not given petitioner for monies borrowed during the period involved, and (c) credit was not given for use of a cer-

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* Sitting in the Fourth Circuit by designation of the Chief Justice.

1. *William G. Lias*, 24 T. C. 280 (1955).

tain distributive share of the profits of one of the enterprises in which petitioner was engaged; and (3) that the Tax Court erroneously found fraud and erroneously found that the statute of limitations did not bar the deficiencies for 1942, 1943 and 1944.

The Supreme Court, in *Holland v. United States*,[2] approved the use of the net worth method of ascertaining net income in certain classes of cases. Even prior to that the Court had approved the use of the method where the owner of a network of gambling houses had received unreported income in a substantial amount.[3] The present case presents a situation similar to the ones faced in those cases. The application of the net worth method is thus firmly established. But petitioner urges that the Commissioner and the Tax Court in the case at bar extended the use of the method beyond permissible bounds.

The taxing authorities faced an unusual problem in attempting to ascertain the accuracy of the petitioner's income tax returns. During the taxable years here involved he received income from five partnerships, in which he and his brother, John Lias, were partners, and from seven corporations, or which he and members of his family were record owners. The revenue agents ascertained that the petitioner carried out many large cash transactions as to which no records were kept by him. He stated repeatedly to the agents that all assets, regardless of whether they were in the names of his wife, brother, mother-in-law or brothers-in-law, were

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2. 348 U. S. 121, 99 L. Ed. 150, 75 S. Ct. 127 (1954).

3. *United States v. Johnson*, 319 U. S. 503, 87 L. Ed. 1546, 63 S. Ct. 1233 (1943).

his to do with as he saw fit. He was unable to identify the source of funds used to acquire various assets. He refused to furnish a net worth statement. Corporate dividends were not paid in accordance with stock record ownership. Stocks of record were not in the names of the true owners. Bank accounts and assets other than cash were shifted from one name to another. The Tax Court found that 'The petitioner so conducted his own affairs and those of the 'Lias Group' as to make it impossible to identify the individual ownership of assets." Faced with this situation the revenue agents made a net worth computation on the Lias family group as a whole. They then allocated to the wife, brother, mother-in-law and brothers-in-law the amounts of net income on which they had paid income tax. The balance of the net income shown by the net worth computation they allocated to petitioner. When the case came on for trial before the Tax Court the Commissioner established with meticulous detail the computations of his agents. Petitioner took the stand and, without documentary or other support, proffered his explanations. He was on the stand for several days. The Tax Court concluded: "Making due allowance for the petitioner's unfortunate position the Court, after a considered appraisal, is not disposed to give any credibility to his unsupported testimony." The court also said "He was evasive, contradictory, and unresponsive."

Some of the figures are startling. For the year 1945, the year of the maximum tax deficiency, the total net income reported by the family group, as adjusted with the revenue agents, was $121,977.54, and the net income reported by petitioner was $76,336.18, or a total of $198,313.72. The net assets of the group increased by

$540,575.21 during that year, and total expenditures of $245,456.03 were made, indicating a consolidated net income of some $785,000. Among the events of the year was the issue to petitioner and his wife of stock in Laconia, Inc., at a cost of $235,194.98. For part of this stock Laconia, Inc., received a building known as the Firestone Building, which petitioner had purchased in 1944 for cash in the amount of $200,000, placing the title in the name of his wife. During the year 1945 petitioner purchased with cash $75,000 of United States Treasury Bonds. In that year a bank account in the name of petitioner and his brother, John, was closed out by transferring some $51,000 to a savings account in the name of petitioner and his wife. During the year petitioner and his wife purchased a residence for $46,000 cash. During the year he advanced $69,676.34 to Laconia, Inc., on open account, and the next year, against the cash thus advanced, stock was issued to petitioner, his wife, his brother, his nephew, and the latter's wife. During the year 1945 five new bank accounts were opened and seven were closed. The agents found that during the year cash was advanced to Wheeling Downs, Inc., in the amount of $167,500. These details are not recited as a full explanation of the computations but are given as illustrative of the factual background with which the cases are concerned.

The agents were unable to find property in any considerable amounts belonging to members of the family. The various partnerships and corporations were all engaged in gambling enterprises of some sort, and the petitioner was undoubtedly the owner, backer and operator of those enterprises. The Tax Court found as a fact that the bank accounts and certain real estate and stock be-

longed to the petitioner. It found that "It was the practice of the petitioner to place bank accounts, real estate, and stock in the names of others than the true owners." In this respect the Tax Court made reference to findings made by the United States District Court for the Northern District of West Virginia in connection with the appointment of receivers for the petitioner and five corporations alleged to have been owned and controlled by him.[4] These were five of the seven corporations here involved. The Tax Court concluded:

> "While the consolidated family net worth technique does not appear to have been resorted to heretofore, we think its use is permissible as embraced within the scope of the net worth technique in civil cases of the character under consideration and involving the complexities and unprecedented circumstances presented. In our opinion no substantial injury results to the petitioner. Extraordinary situations require the adoption of unusual methods to resolve them. Mindful of the pitfalls inherent in any net worth method, we approve the respondent's use of the consolidated net worth method in the instant proceedings."

We agree with the foregoing statement.

Petitioner says that the Commissioner's computation of the opening net worth of the family group was erroneous. This net worth was $164,732.97. Petitioner says (Brief, pp. 68-69) that an examination of the entire record "leaves one with a firm conviction that he was a man of substantial means up to and including January

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4. *United States v. Lias,* 103 Fed. Supp. 341 (1952) *aff'd,* 196 Fed. (2d) 90 (4th Cir. 1952).

1, 1942, and that he had accumulated savings as of the beginning of the period of between $850,000 and $950,000, which included about $700,000 in cash." In the first place petitioner offered no evidence whatsoever to support a claim of any such amounts of savings or cash. He says in his brief that "It is totally unrealistic, in view of the uncontradicted evidence in this case as to the extent of the taxpayer's bootlegging and gambling activities in the 1920's and 1930's, and in view of * * * his mode of living and his successful businesses throughout the period prior to the starting period," to make a finding that he had no cash. Petitioner himself offered no evidence persuasive to the Tax Court as to large amounts of savings or cash as of January 1, 1942, and, as we have indicated, none of his family except one took the witness stand. No documentary proof was offered. In the second place the revenue agents, despite an exhaustive and meticulous search, were unable to uncover any evidence of substantial savings or cash. In the third place the petitioner conclusively established to the Commissioner of Internal Revenue, when his returns for the years up to 1941 were under consideration, that he had no funds whatsoever. The details are recited by the Tax Court in its opinion. From 1937 through 1941 the revenue authorities were actively endeavoring to find property of the petitioner with which to meet his tax liabilities. The taxpayer made numerous offers in compromise based upon inability to pay, and at one point he gave a series of postdated checks on the ground that he then had no funds with which to meet his obligations. We agree with the Tax Court that the petitioner utterly failed to establish error in the Commissioner's opening net worth statement.

Petitioner urges that the allocation of the group net income among the several members of the group was erroneous. The question is: If this total income was the income of the group, what part of it was the income of each member? This is a problem of presumption and proof. The Tax Court found, as we have indicated, that petitioner frequently carried his own assets in the names of his wife, his brother, and others. It found that it was impossible to separate the individuals and compute their several net worths. It found, as we have indicated, that petitioner owned the assets involved. As the matter came to the Tax Court, the Commissioner had determined that the shares of the persons other than petitioner were the amounts reported by them as income, after the adjustments made with the revenue agents. That determination was at that point presumptively correct.[5] The whole matter was then opened wide before the Tax Court. But no member of the group appeared to claim participation in excess of the amounts taxed to them. None appeared on the witness stand except a brother-in-law, and he did not claim ownership of any such excess amount. The Tax Court heard petitioner for days and did not believe his shifting of the burden to the other members of his family. As we have already emphasized, no documentary proof was presented. On the other hand the Commissioner produced much proof, and the findings and opinion of the Tax Court are replete with facts indicating that petitioner and his operations were the source of the income. Upon this state of the record we cannot say that the conclusions of the Tax

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5. *Helvering v. Nat. Grocery Co.*, 304 U. S. 282, 82 L. Ed. 1346, 58 S. Ct. 932 (1938).

Court as to the true owners of this income are clearly erroneous. We must therefore affirm the findings.

The other points raised by petitioner, which we have listed in the beginning of this opinion, are discussed and disposed of in the findings and opinion of the Tax Court. We agree with that court's treatment and disposition of the items.

The amounts of net income found by the Tax Court to have been omitted from the petitioner's tax returns, and the circumstances under which the omissions are shown to have occurred, are amply sufficient to support the fraud penalties.

Fraud having been established, the statute of limitations does not apply.

Affirmed.